DOW THEORY LETTERS INC.

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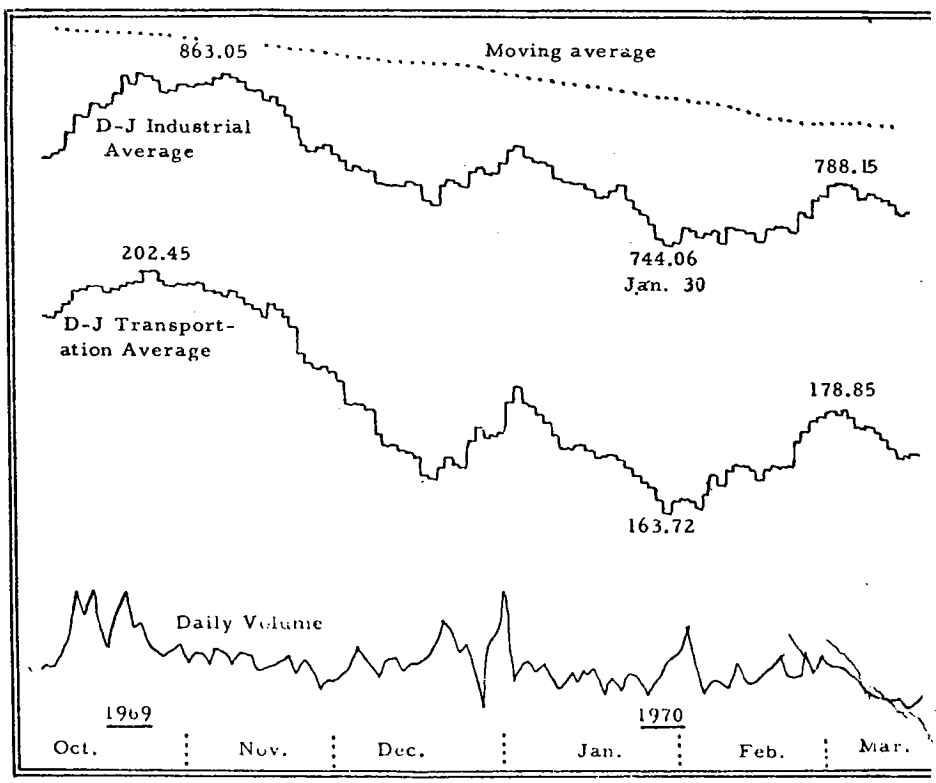
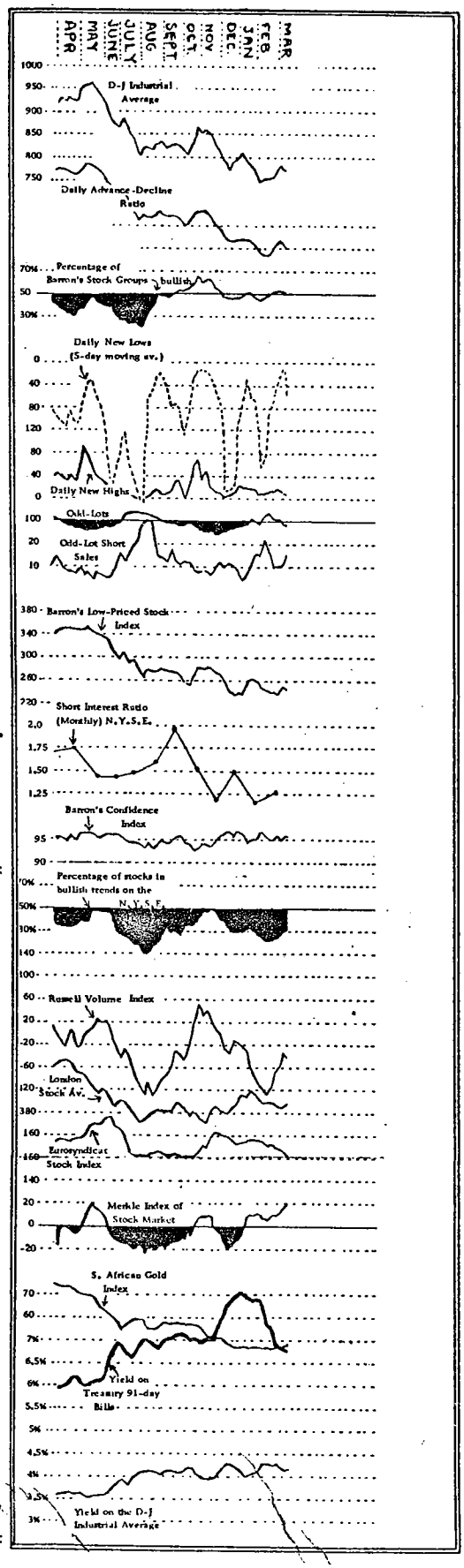
THE MARKET: (From the Wall → Street Journal, March 13.) To my mind, the most important word in the paragraph to the right is "surprised." Most analysts were surprised by the decline, and as we can see the statistics are now causing some of them to change their minds about the picture ahead. And that's how primary bear markets work. Major bear markets always bring conditions which are worse than the prophets foresee; there is always that unpleasant element of surprise.

BUSINESS INVENTORIES plunged $470 million to a seasonally adjusted $165.63 billion in January, for the sharpest drop in almost nine years. Most analysts were surprised by the decline, saying it could indicate businessmen expect very poor sales for several months.

Pierre Rinfret, a top "glamor" economist and a key figure in the 1968 Presidential campaign seems to have quietly made some revisions. Late last year he was predicting that 1970 would see the greatest boom in American history. But before a Senate Banking subcommittee last week he stated that the "direct cost" of fair success in holding back inflation "will be measured by increasing unemployment," perhaps to 5.5% of the labor force by the end of 1970. Where is Mr. Rinfret's giant boom? At the same time, Alan Greenspan, another leading economist and one close to the Administration, said that unemployment will climb steadily to 5.6% in next year's June quarter.

I feel that the great mass of Americans now believe that the Administration is in the process of manufacturing a mild recession for the purpose of squashing inflation. Obviously, the Administration is being independently aided by the Federal Reserve Board. And all this may be true enough. But I suspect that inherent in this thinking is a sort of built-in optimism and bullishness. For if the Government can



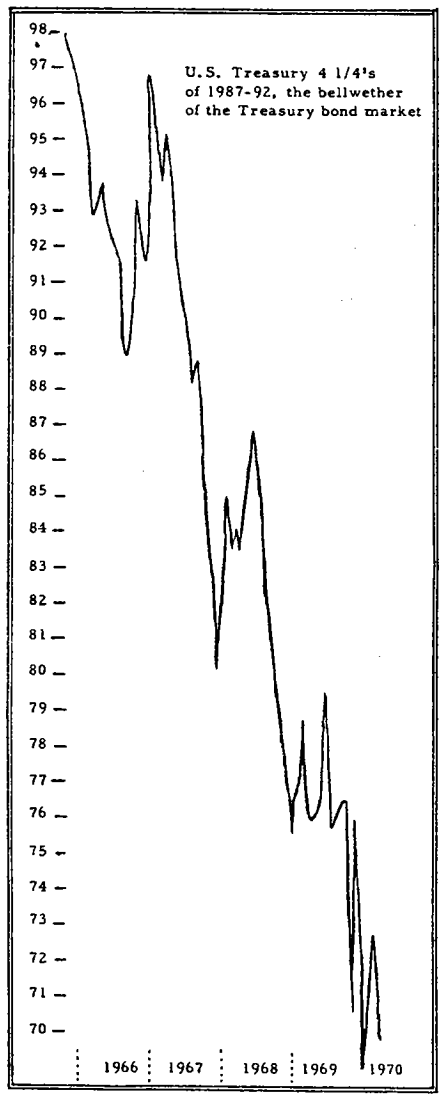


reverse its policy within a matter of days or weeks? All the Administration has to do is "announce" that it is going to spur the economy and presto, off we go again into the wild blue yonder. And if the great primary trend of the market and the economy were now bullish, I would be the first to agree with that logic.

But as I see it, a major bear market began in 1966. The tidal force of a primary movement can be temporarily arrested or held back, but in the end the tide, not man, has its way. This, I feel, is the lesson that the Government, the famous economists and the American people will learn during the remaining years of this bear market.

Meanwhile, each week seems to produce its new package of bad news. Chrysler moving deep into the loss column, Lockheed against the wall, major airlines reeling under financial problems, bombings in New York, a "new war" in Laos, auto sales declining, unemployment up, day after day the dismal news emerges. The majority of investors are still banking on the idea that the 744.06 Dow low of January 30, 1970 discounted the worst that lies ahead. They are erring in equating this bear market with the declines of 1957, 1960 or 1962. As I see it, the 744.06 low of January is far, far from the point where the worst will actually be discounted.

I have been pondering day after day about the situation, and I am beginning to sense that the next major decline (below 744.06) will, when it terminates, also end the second phase of this bear market. Remember, the second (psychological) phase of a bear market is the one in which the market reflects obviously deteriorating business conditions. This is the way the market is acting now, and it is the way the business picture is developing. From wherever the next major downward leg ends (but I would have to study it when we get there), I would guess that we will have a good advance. After that the bear market will wind up with what I am surer and surer will be a disastrous, extended, final third phase. The third phase could be more severe and last longer than anyone now imagines.



My reason for believing that the third phase will be so severe is that far too much bullishness has been retained by the bear market so far. Here, four years and a month after the bull market peak, there is an incredible amount of optimism still remaining. It would appear to me that the final or third phase of this bear market is going to be the one that ultimately grinds out the last sparks of optimism. That is going to mean far lower prices, low volume, terrible business and a sea of political, social and economic disorders.

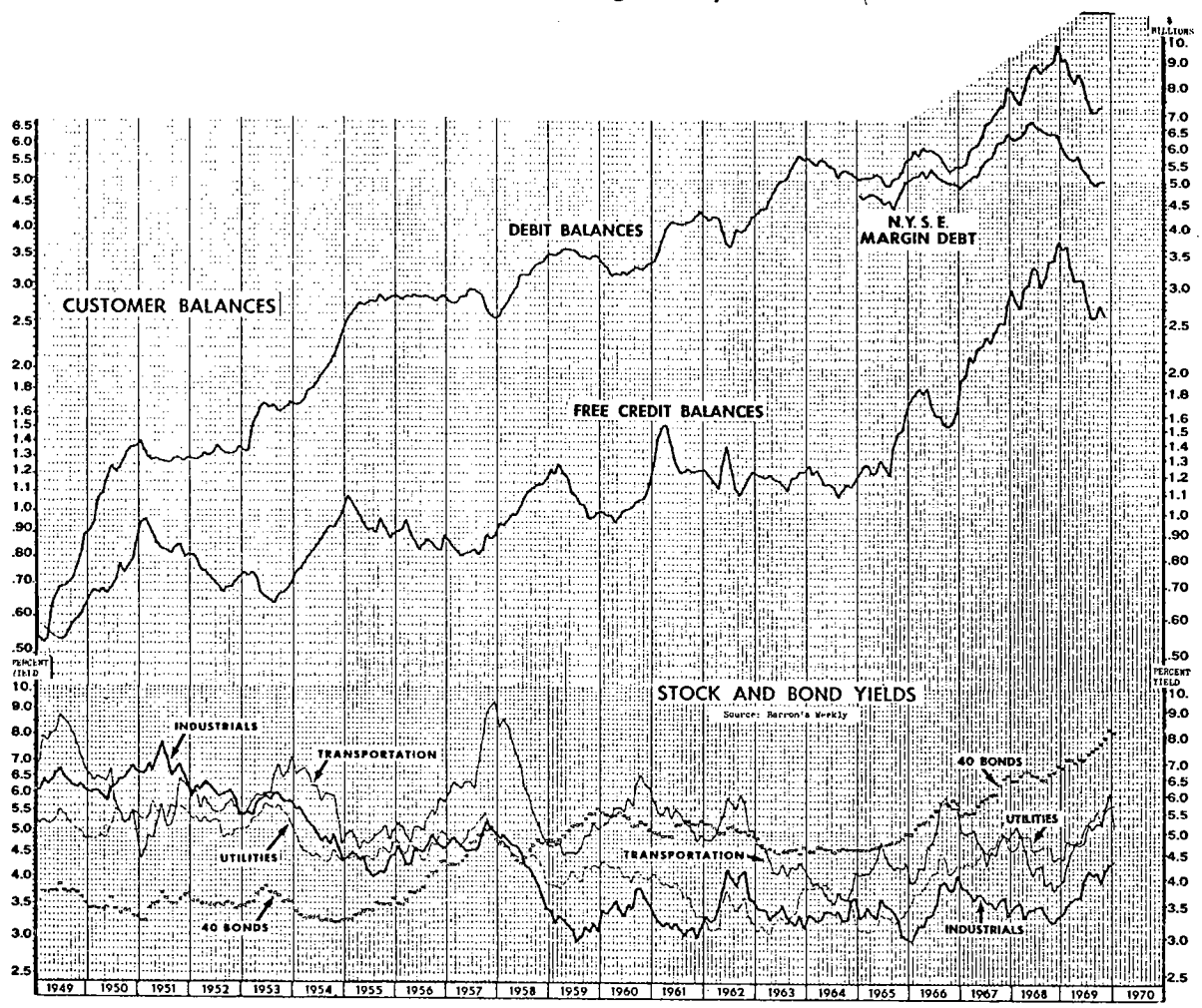
To illustrate one possible area of current disillusionment, I have included a chart of the U.S. Treasury 4¼ bond of 1987-92, considered to be the bellwether of the Treasury bond market. From a late-1969 low of below 69, this bond rallied to a February, 1970 peak of 73 10/32nd's bid. Thus it reflected the widely-advertised bond rally of 1970, a rally which the experts predicted was a bounce off the "final bottom." But few have noted that the bond market is now facing its greatest pile-up in history with a record $5 billion in bonds coming to market in the next 60 days. The bond market has very definitely noticed the flood. By early this week the bellwether 4¼'s had given up the majority of their rally gains, and they were selling for just over a bid of under 70, meaning that they were roughly 1 point from their historic low. If bonds break to new lows (and this would, of course, mean new highs for yields) we will have another "shocker." I trust, however, that no readers of these reports will be shocked by new lows in the bond market and new historic highs in yields.

As to the actual market, note on the page 1 chart that the Industrials rallied from the January 30 lows, establishing recovery peaks in early March of 788.15 for Industrials and 178.85 for Rails. A decline carried to March 21, during which approximately half of the previous rally gains were erased. It would now be "normal" for the Averages to mount a second rally, and it is here that inherent strength or weakness will be determined.

Disregarding all other technical factors, if the rally which began from the January 30 lows is to extend into a true secondary (upward) correction, it will be necessary for the Industrial and Rail Averages to hurdle their early-March highs of 788.15 and 178.85. Conversely, a failure of one or both components to better the early March highs will indicate that the rally has been

nothing more than a brief period of distribution. If so, the next important move would be an attack on the 1970 lows, those points being identified on the page 1 chart.

In the last two Letters I offered the opinion that the late-January action was unsatisfactory from the standpoint of establishing an important secondary bottom. While strength could conceivably build up and the technical situation improve over the period ahead, I still hold the opinion expressed in previous Letters. I will also remind readers that historically (see Letter 454) no major advance was ever mounted from an area wherein the short interest in the 30 Dow stocks was below 1.0 (as it is now). Also of interest is the fact that the "Most Active Stock" Index dropped to minus 8 last week, this marking the first minus on the Index since the week ending February 13.


DEBIT BALANCES
N.Y.S.E. MARGIN DEBT
CUSTOMER BALANCES
FREE CREDIT BALANCES
STOCK AND BOND YIELDS
Source: Barron's Weekly
INDUSTRIALS
TRANSPORTATION
UTILITIES
40 BONDS
1949 1950 1951 1952 1953 1954 1955 1956 1957 1958 1959 1960 1961 1962 1963 1964 1965 1966 1967 1968 1969 1970

INDICATORS: My friend, Dr. Sloan Wilson of Kansas, developed a great many valuable stock market studies during the time he was publishing his market service. Quite a few of Wilson's studies concerned themselves with stock market credit. Dr. Wilson noted that during primary bull markets the debit balances in brokerage house accounts tended to build steadily higher as speculators borrowed more and more against their margin accounts. In fact, Wilson termed the margin account the "speculator's greatest tool," and he noted that the use of margin was characteristic of the professional.

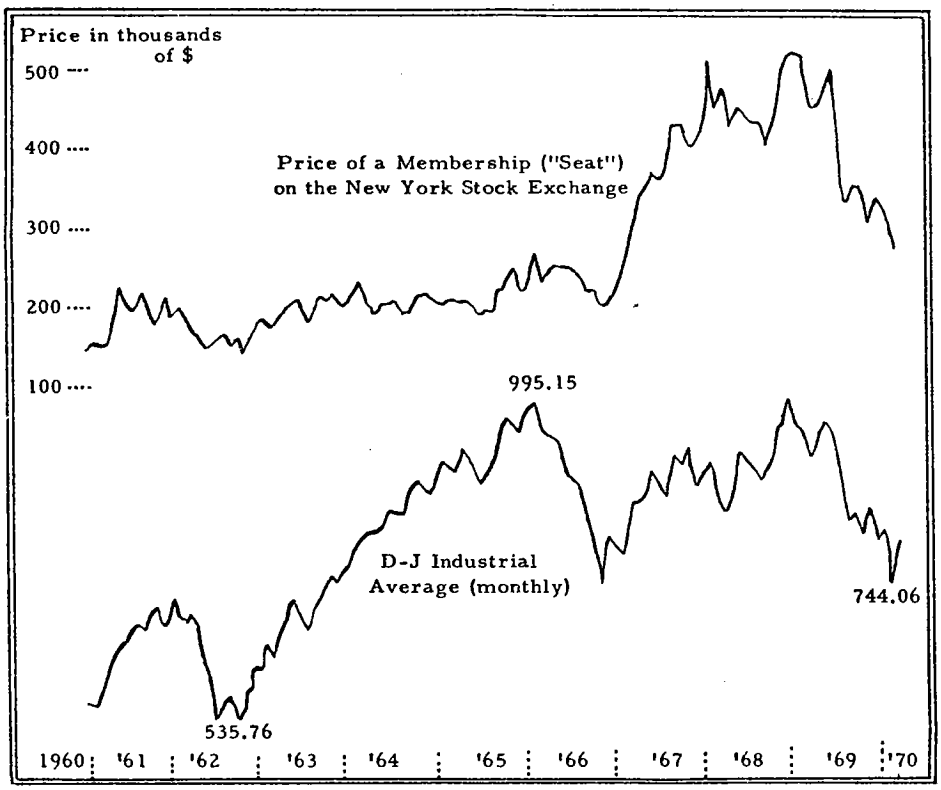
Thus debit balances, said Wilson, rise to peak after peak as a primary bull market progresses. When the debit balances touch their final peak the bull market is probably over, and then the reverse phenomenon occurs as a primary bear market comes into being. As the bear market progresses the speculator leaves the market and with him goes his margin account. Thus, debit balances continue to drop throughout the length of a bear market.

Dr. Wilson talked about the "round trip" phenomenon during the cycle of a bull market and the ensuing bear market. He noted that in the course of each bear market the debit balances tend to sink back to the level they were at during the early stages of the preceding bull market. In other words, the debits make a round trip, and before the bear market is over the small debit balances give proof of the fact that the speculator and his margin had finally left the Wall Street scene.

I am including an excellent chart on page 3 put out by Securities Research, 208 Newbury St., Boston, Mass. 02116. This chart traces the great surge in debit balances, starting with a figure of roughly $.5 billion in 1949 (when the bull market began) and building up to almost $10 billion at the end of 1968. Thus as more and more customers borrowed greater and greater amounts, an amazing tower of debit balances was built in Wall Street. But if Dr. Wilson is correct, those debit balances will collapse before this primary bear market is over, perhaps even sinking to the 1949 level again. At that point the speculator (the man who works with margin) will be defeated. And at that point, in all probability, a new bull market will be ready to begin.

A second phenomenon is pictures on the chart, and this is the yield cycle. Note (heavy black line at bottom of chart) that during the early stages of the bull market (during 1949-51) the average yield on the 30 Dow stocks was very high— in the 6.5% to 7.5% area. As the bull market continued the average yields decreased. During early 1966, when the bull market was breathing its last, average yields on the Dow had dropped below 3%.

The bear market began in February, 1966, and as stocks declined yields moved higher. Presently, average yields for the Dow stocks are around 4.3%, but it should be remembered that during a bear market yields are not exactly directly proportional to the price movement. The reason is that dividends are cut during a primary bear market even as prices move down (such as the drastic recent cut in the Chrysler dividend). Before this bear market is over, despite dividend cuts and omission of extras, it is probable that average Dow yields will be in the 6% and over zone. At that point, stocks will be sinking into the area where they can be termed "great values" again. New bull markets traditionally begin with stocks at great values.



THE MEMBERS: Membership (i.e., a seat) in the New York Stock Exchange is one of the most exclusive memberships of any club in the world. One of the reasons is that a membership must be purchased, and they do not come cheap. When volume is low and Wall Street is in its "dog days" a membership may appear cheap by today's standards. But when Wall Street is flying so is the rest of the country, and at such times seats on the N.Y.S.E. appear expensive by any standards.

For instance, the low price for a seat in 1949 was $35,000, but those of you who were in business in 1949 remember that $35,000 seemed like an awful lot of money in those days. The low price for the Dow Industrials was 161.60 in 1949, and volume was dragging along at .5 to 1.0 million shares a day. Members, in other words, were not making any killing in Wall Street in 1949.

But 1949 was the beginning of the greatest bull market on record. All through the 1950's and 1960's prices on Wall Street moved higher as did volume. Wall Street, knowing full well the implications of a mighty bull market, bid up the price for seats. The accompanying chart shows what has occurred in prices for Exchange seats and for the Dow Industrials over the past decade (prices are recorded on the first day of each month).

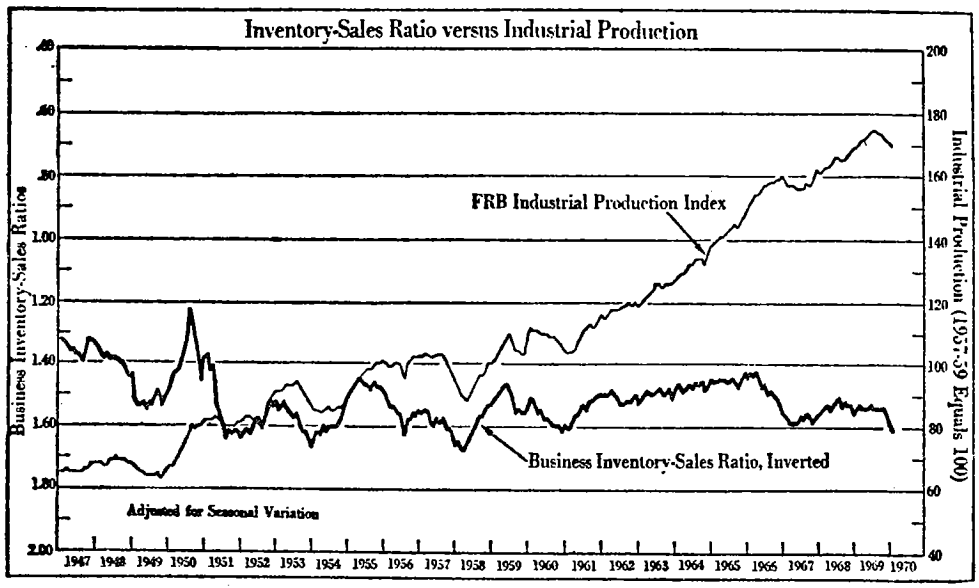
By January, 1968, a seat on the Exchange sold for $515,000, which represented an increase of about 1,350% from the 1949 price, quite a rise. During the same period the price of the Dow rose from 161.60 to its 1966 peak of 995.15, a rise of 520%. Cynics might claim that you would have made twice as much buying a seat as buying the Dow, but that's all rather academic.

With the massive speculation during late 1968 the seat price rose to a double peak during December, 1968 and January, 1969. Then, as the second major swing of the primary bear market took hold, seat prices collapsed. By early 1970 a seat on the Exchange sold for $265,000, roughly half its price of a year ago. This represents a paper loss to N.Y.S.E. members of around $363 million dollars.

Half a century ago, that Great editor of the Wall Street Journal, William P. Hamilton, wrote: "But Wall Street is inherently bullish. One reason for this is that the financial district does not make money in a bear market, contrary to the ideas of people who think that then is the time when the Street reaps its harvest, and wickedly turns disaster to its own advantage. Wall Street lives on commissions, and not on what it might make by selling short the securities it originates. Large trading and large commissions go together. They are a feature of a bull market, but never one of a bear market."

Any one who disbelieves Hamilton's observations might study the chart of Exchange seat prices. Is it any wonder that Wall Street has a vested interest in bullishness? Is it any wonder that there is a disposition to disbelieve in primary bear markets? It has always been my observation that people believe what they want to believe, and Wall Street and its Exchange members are no exception.

SALES & INVENTORIES: The accompanying chart from the Journal of Commerce (thanks to Humphrey Neill) shows an interesting picture, the critical sales to inventory ratio. When business is expanding, and we note on the chart that the long upward rise in the FRB Production Index signifies that it has been expanding), manufacturers tend to become increasingly bullish. Consequently, they also seek to build up their inventories in anticipation of increasing business (and as a hedge against inflation).

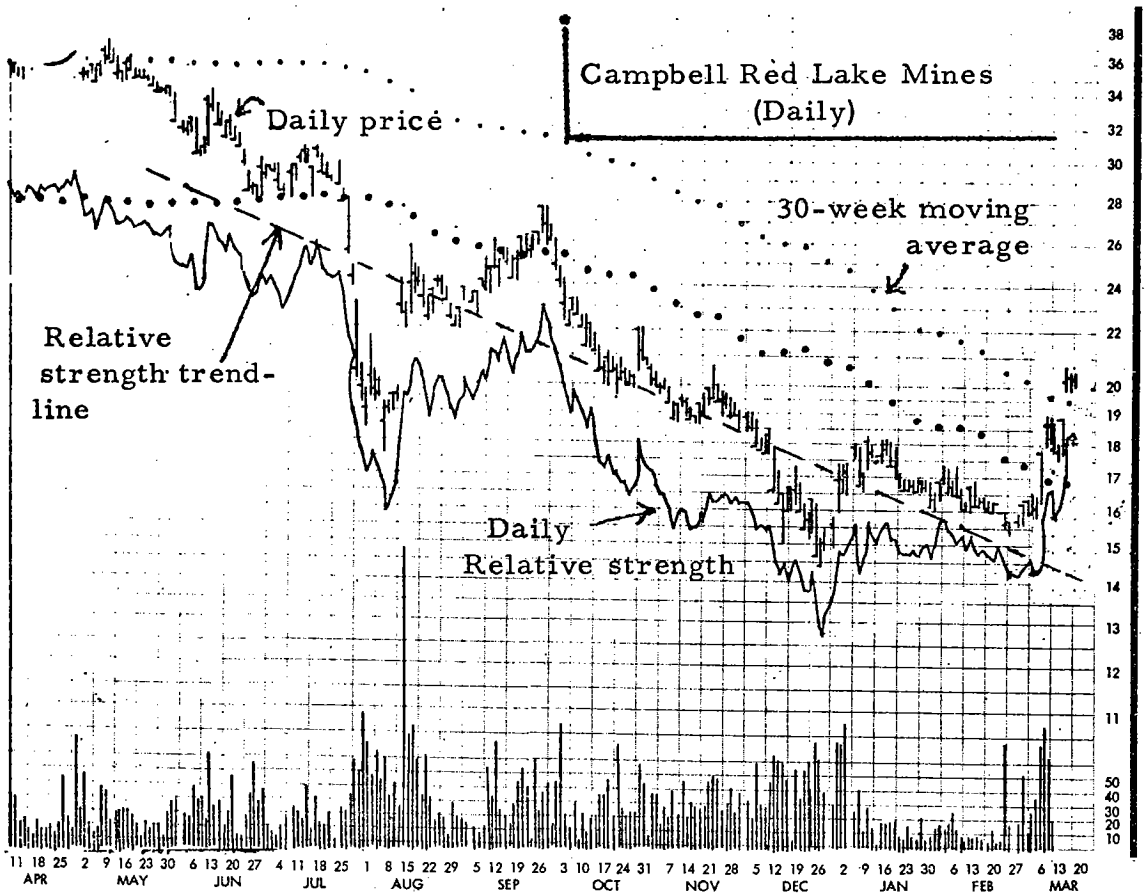

Inventory-Sales Ratio versus Industrial Production
FRB Industrial Production Index
Business Inventory-Sales Ratio, Inverted
Adjusted for Seasonal Variation
Business Inventory-Sales Ratio
Industrial Production (1957-59 Equals 100)
1947 1948 1949 1950 1951 1952 1953 1954 1955 1956 1957 1958 1959 1960 1961 1962 1963 1964 1965 1966 1967 1968 1969 1970

Then, as a slowdown in sales appears, it usually catches manufacturers either unaware or unable to adjust their inventories fast enough. Those who see the slowdown coming may cut back their inventory building in anticipation. This is termed voluntary inventory cutting. But in most cases a belated recognition of a sales slowdown hits manufacturers. Then they are faced with a problem: Sales are declining, and they have far too many goods coming in on order. The next step is cancelling unwanted orders and cutting back on future orders. This is the process known as involuntary inventory cutting, and it is undoubtedly happening now.

Note on the chart that when the inventory-sales ratio turns down prior to an economic recession, it usually does so in the pattern of a large, downward zig-zag. This is what occurred during 1950 to 1953 prior to the 1953-54 recession, it happened again during 1955 to 1957, prior to the 1957-58 recession. It occurred in a very minor way during 1959 to 1960 prior to the gentle 1960 slowdown. And during 1965 to 1969, a huge downward zig-zag has occurred.

What this latest large declining zig-zag in the investory-sales ratio is going to mean in terms of the economy, no one can yet know. It seems to me, that it has the potential for calling for real trouble in the economy. Much will depend on the ability of manufacturers to cut back on inventories during the period ahead, or on the ability of manufacturers to step up sales and thereby chew into their inventories. A continued downturn in the ratio will mean that manufacturers have failed on both counts.

NOTE: The response to the special offer to regular subscribers in view of the price increase was positively amazing. I wish I could thank each subscriber personally, but I have neither the energy nor enough hours. Dozens of letters were received, and again I wish to thank subscribers for all the kind words. Nobody even complained about the small print in the reports, so I will not offer any older readers a gratis magnifying glass (I guess with inflation I should offer wall projectors instead of magnifying glasses). But seriously, I do wish to thank all my readers, and if I do not have time to answer you letter please do not think I have failed to appreciate reading your letter.



STOCKS: I have received many inquiries from frightened readers who have read a service which reports that they feel the U.S. will nationalize ADR's and thus confiscate or at least hold-up ownership of South African gold shares. Now, anything can happen. A bear market collapse could bring fascism to the U.S., anarchy could reign, the dollar could collapse, California could sink into the Pacific ocean, a plague could sweep across the face of the earth, Chinese frogmen could creep out of the breakers in Virginia Beach.

Personally, I do not feel that the U.S. would nationalize ADR's, even in the advent of a huge raise in the price of gold. First of all, the number of U.S. holders of S. African gold shares is miniscule, and the moral implications of such an act would be horrendous. Secondly, what good would it do the U.S. to take away our poor little ADR's? Gold stocks don't run up the price of gold; in the end the price of gold controls the price of gold stocks. Gold stocks reflect fundamental conditions which may or may not result in a gold price hike. The stocks are merely a tiny barometer, and I doubt that Washington would smash the barometer. Furthermore, I doubt that President Nixon, who is ostensibly at least aware of the value of a free market, would stoop to such piracy.

So, while on the subject of gold I might as well turn to a well-known gold share, Campbell Red Lake (chart courtesy of Traders Research, 101 Cherry St., Alton, Ill.62002). This chart is not as complicated as it looks, it just has alot on it. The daily price action is shown from April, 1969 to date.

Note that over the past few weeks the price has surged above the fine dotted line which is the 30-week moving average of price. That is a good sign for CRK. Next we see that the daily relative strength line has reversed a long downtrend line, and this means that on a trend basis CRK has been acting better than the market. Actually, the relative strength line on CRK has been rising since mid-December. The heavy dotted line is the 30-week moving average of relative strength, and the daily RS line has bettered this dotted line, thus providing a bullish signal. In the Letter of February 6, I stated that I thought the gold shares had bottomed out and represented good buys at the time. This chart goes a long way towards confirming that opinion.